



Treasury Inspector General for Tax Administration

LIKE-KIND EXCHANGES REQUIRE OVERSIGHT TO ENSURE TAXPAYER COMPLIANCE

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Highlights

Highlights of Report Number: 2007-30-172 to the Internal Revenue Service Commissioners for the Small Business/Self-Employed and Wage and Investment Divisions.

IMPACT ON TAXPAYERS

The practice of deferring capital gains tax through like-kind exchanges is increasing in popularity. However, if taxpayers do not specifically follow the rules for like-kind exchanges, they could be held liable for taxes, penalties, and interest on their transactions. Therefore, it is important for the Internal Revenue Service (IRS) to provide specific and consistent guidance to taxpayers on this provision of the tax law.

WHY TIGTA DID THE AUDIT

This audit was initiated to evaluate the IRS' oversight of the deferment of capital gains tax through like-kind exchanges. TIGTA also determined whether taxpayers' use of this investment strategy is growing and whether this poses any specific problems for the IRS.

Under normal circumstances, when a taxpayer sells a business or investment property, tax must be paid on the gain. A like-kind exchange allows an exception to payment of the capital gains tax. When taxpayers sell businesses or investment real estate and replace them with different businesses or investment properties using an exchange, they can defer payment of the capital gains tax normally required on these sales. As long as a property used for business or investment is replaced with similar property, no gain or loss is recognized at that time; rather, it is deferred until the eventual sale of the replacement property.

A taxpayer must report an exchange to the IRS on Like-Kind Exchanges (Form 8824), which is filed with his or her tax return for the year during which the exchange took place. The IRS Office of Research, Analysis, and Statistics reported that in Tax Year 2004 taxpayers filed more than 338,500 Forms 8824 claiming deferred gains (or losses) of more than \$73.6 billion. While this represents a doubling of the number of like-kind exchanges reported in 1998, the total dollar amounts deferred more than tripled.

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WHAT TIGTA FOUND

Like-kind exchanges require more IRS oversight to ensure taxpayers comply with tax laws. Some IRS guidance to taxpayers needs revision to provide more consistent and complete information regarding like-kind exchange filing requirements. In addition, the IRS regulations for like-kind exchanges of second and vacation homes are complex and may be unclear to taxpayers, and little information exists with respect to a published position by the IRS on like-kind exchanges involving such properties. The absence of clarification leaves unrebutted the sales pitch of like-kind exchange promoters who may encourage taxpayers to improperly claim deferral of capital gains through "tax-free" exchanges.

WHAT TIGTA RECOMMENDED

TIGTA recommended the Director, Research, Small Business/Self-Employed Division, conduct a study of issue-related returns selected by the National Research Program. At the conclusion of the study, the Research function would recommend to the Small Business/Self-Employed Division Examination function what particular data should be captured in future National Research Programs in order to ensure appropriate IRS oversight of taxpayer compliance with tax laws pertaining to like-kind exchanges. TIGTA also recommended the Commissioner, Wage and Investment Division, update some current guidance regarding Form 8824 and provide additional guidance to taxpayers regarding the rules and regulations governing like-kind exchanges of second and vacation homes that were not used exclusively by owners.

In their response to the report, IRS officials agreed with all of the recommendations. The IRS plans to conduct a research study of reporting and compliance issues associated with like-kind exchanges and share the results with the appropriate function. In addition, the IRS agreed to revise instructions for certain tax forms; update the information available on IRS.gov; and provide additional guidance on like-kind exchanges to taxpayers, practitioners, and stakeholders.

READ THE FULL REPORT

To view the report, including the scope, methodology, and full IRS response, go to:

<http://www.treas.gov/tigta/auditreports/2007reports/200730172fr.pdf>.

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